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January 28, 2000

Ms. Lucy Querques Denett
Associate Director
Minerals Management Service
United States Department of the Interior
1849 C Street, NW
Washington, D.C. 20240

Re: Comments on Proposed Oil Valuation Rule
As published December 30, 1999
64 Fed. Reg. 73820, *et seq.*

Dear Ms. Denett,

Union Oil Company of California ("Unocal") is submitting its comments in response to the captioned Minerals Management Service supplementary proposed rule on establishing oil value for royalty due on federal leases. In making these comments, we wish to incorporate by reference the comments jointly submitted by the American Petroleum Institute, the Independent Petroleum Association of America, the Domestic Petroleum Council and the United States Oil and Gas Association ("the Joint Comments"). Unocal is directly affected by this rulemaking as a federal lessee active in the Gulf of Mexico, including deep water exploration efforts which are expected to yield mostly oil. Also, Unocal has an affiliate, Unocal Pipeline Company, which in some instances transports oil on behalf of Unocal.

Unocal does not believe that the comment period for this proposed rulemaking was sufficient to let federal lessees analyze the changes since the last proposal on oil royalty valuation and to prepare comments. In attempting to analyze the proposed rule and its effect on Unocal, we find its provisions to be difficult to comprehend and believe that as drafted the rule will only lead to greater uncertainty and a correspondingly greater administrative burden on both industry and the MMS. The proposed rule has several provisions that leave a lessee open to second guessing by the MMS and its auditors. In the workshop held on January 19th on this proposed rule, Mr. Schaumberg commented that he was not aware of any instance where the MMS had "second-guessed" a producer. At least one industry representative, however, listed several examples in response to that comment. In the past two years Unocal has had similar experiences. The vague and poorly drafted rules being proposed will only increase these instances of second guessing by the MMS.

The actual indices to be used or how the index prices will be calculated is not included in the proposed rule, nor is there any indication of when the MMS will publish the approved indices. There is nothing in the rule that requires the MMS to publish the approved indices or to state how to calculate the index price in a sufficient time to permit lessees to calculate the royalty and pay it in accordance with the lease and MMS regulations. Until Unocal has seen the actual indices to be used and can see how the royalties are to be calculated, it cannot tell whether it should select an index or tracing valuation method for any sales to its affiliate, or what changes, if any, will be required in its accounting systems. According to the preamble to the rulemaking the MMS intends to issue the rule on March 15 and have it be effective on June 1st. Until we have more information, we cannot know if we will be in a position to comply with the rules and report royalties as required in the short time given between the date the rule will be issued and its effective date. We are assuming that the rule will be effective as to production after June 1st and not on royalties payable after June 1st.

Unocal strongly supports the recommendations in the Joint Comments in favor of a royalty in kind program for oil as being the best way to start reducing the administrative burden on both the MMS and the producer in accounting for and valuing production.

In the Joint Comments, it was mentioned that there have been several comments by industry disputing the MMS' contention that there is not active market at the lease for oil. Unocal would like to add that, based on its experience, it agrees with the Joint Comments and other industry comments about this proposed rule and its prior iterations. Unocal also strongly disagrees with the contention by the MMS that there has been a systemic underpayment of royalties under the current rule. From 1992 until Unocal stopped posting prices, its postings for oil were based on the P-plus market at Cushing, and were, therefore, directly reflective of a market center price. These postings served as the basis for the company's royalty payments and did not constitute "systemic underpayments."

Unocal also strongly disagrees with the proposed requirement that a producer must elect whether to use indices or tracing for all of its federal leases for a two year period. In the January 19th workshop in Houston the MMS said that one reason for this requirement was to avoid confusion by the MMS auditors. Since under the current re-engineering program the emphasis will be on auditing on a property, rather than a company basis, this requirement will not help confusion in valuation since each co-lessee could have a different method of valuation. For example, if the lease is co-owned by Company A, Company B and Company C, Company A could be selling on an arms-length contract to a third party and the valuation would be based on the gross proceeds under that contract. Company B could be selling to an affiliate and select valuation based on tracing. Company C could also be selling to an affiliate, and select valuation based on an index. The auditors would still be dealing with multiple valuation methods on one lease under the proposed rule. If the MMS is going to require a company to indicate whether it is going to use index based valuation or tracing, the information would be in the MMS records whether the selection is on a company wide basis or a lease or field basis, and the method selected by a producer should be readily ascertainable by experienced auditors, based on the MMS' own records. Unocal believes the final rule should allow a producer to select a valuation method on a lease basis.

The other reason given by the MMS for this requirement in the January 19th workshop was to prevent "gaming" by a producer. The valid point was made by one attendee that if both alternatives have been selected by the MMS as valid methods for valuation, no such opportunity for "gaming" by a producer actually exists. What this does accomplish is that if a producer has only one lease or one area of leases in which only one method of royalty valuation will work, it will be tied to that method for the rest of its leases in other areas where the other method might be more readily utilized and result in less administrative burden to both the producer and the MMS. Unocal also believes that making the producer select a valuation method for two years is an unreasonable length of time, given that sales may be on a monthly basis to various purchasers, and one method may be more appropriate one month and not the next.

The definition of affiliate should be clarified to specifically exclude co-lessees, joint ventures and tax partnerships, all of which are common ways lease ownership is shared, and to recognize that a sale to a co-lessee can be an arms-length transaction, whether the sale is under a formal contract or to the Operator under the terms of an Operating Agreement.

In the preamble, at page 73840, the MMS estimates that requests for value determinations and approval of location/quality adjustments from the MMS under 30 CFR 206.107 and 206.112 as proposed will be no more than eight from all of industry per year. Ignoring the initial flurry of requests that will hit the MMS if this rule is promulgated as proposed, Unocal estimates that it alone will be making more than eight requests per year. The purchaser of the oil can vary from month to month. Each different purchaser may be looking for oil for different locations, resulting in differing location differentials, or if the index changes, there may be need for varying quality differentials, even though the quality of the oil itself does not vary. Different transactions may require a valuation request. Exactly how many requests will necessarily be made is difficult to estimate because of the numerous problems with the proposed rule. As mentioned above, which actual indices are to be used or how the index prices are to be calculated are not included in the proposed rule. Nor is there any indication of when the MMS will publish such approved indices. The MMS may wish to defer this to allow for flexibility. However, this also means that as of this point in time, industry has no way to calculate the impact of the rulemaking, but can only speculate. Also, under existing indices, there are large areas, such as High Island, that have no published index and there is nothing in the rule as proposed that would tell a High Island lessee how to calculate its royalty.

The proposed rule is not clear about how spot prices will be calculated, it being Unocal's position that the calculation should be based on the month of production, per the lease, and not using another method. In its preamble at page 73831, the MMS' explanation of how to calculate an index based royalty states "You would calculate the daily mean sport price by averaging the daily high and low prices for the month in the selected publication. You would use only the days and corresponding spot prices for which such prices are published. You would be required to adjust the value for applicable location and quality differentials, and you could adjust it for transportation costs...". Spot prices can be based on the price for the actual month of production, which is the "calendar price." Spot prices can also be based on the "trade month." The trade month for crude that will be actually produced during the month of March 2000 actually runs from January 26 through February 25th. As written, the proposed rule does not define "spot price" as the calendar price for the month of production, which could lead to confusion on the part of the producer and second guessing by the MMS and its auditors. The same confusion exists about the quality and location differential to be used, since it can vary between the calendar price and the trading month.

Moreover, Unocal takes strong issue with the MMS' position that these spot prices accurately reflect the prevailing prices at which most oil is actually sold at market center locations. During the past five years Unocal and its trading affiliate have been unable to obtain these published spot prices for the oil it sells. Requiring Unocal to pay royalty on a price it does not in fact achieve will force the company to pay a higher percentage royalty on each barrel of oil it produces than the percentage required under its federal lease.

Unocal also disagrees with the MMS's contention that it is fair to allow a lessee with an arm's length transportation contract to use the FERC tariff while requiring a lessee with a contract with an affiliate which the MMS considers to be a non-arm's length contract, to use the cost of service as determined under the proposed rule. A FERC tariff is set by FERC based on a reasonable rate of return for the pipeline. In the preamble at page 73835 the MMS states that "We continue to believe that FERC tariffs often exceed the transporter's actual costs." By "transporter" we assume the MMS means the pipeline affiliate. There is no indication there is any factual basis for this "belief." The FERC is the federal agency with statutory oversight and an agency expertise in what is an appropriate tariff for a pipeline and whether that tariff exceeds or is less than a pipeline company's "actual costs." Unocal wishes to point out that the costs the proposed rule refers to as "actual costs" are not the actual costs of the affiliate. What is being calculated under the rule are the allowed costs that can be deducted according to the MMS.

The MMS then goes on to state in the preamble that "MMS also maintains that where producing and transporting affiliates are involved, the entity claiming the allowance should be able to acquire any needed records from its affiliates." This statement ignores the possible consequences of a pipeline company sharing such information with an affiliate. The pipeline affiliate may then be required to share this information with other, non-affiliated shippers. This would put pipelines that are affiliated with producers at a disadvantage with their competitors that are not affiliated with a producer that owns federal leases and therefore that will not be required to share the costs calculated under the proposed rule. It should be noted that pipeline information disclosed to FERC under a ratemaking case are often disclosed subject to a protective order that protects what most companies consider confidential information. The proposed rulemaking does not impose any such protective order on the MMS, on the affiliate that will receive the information, on non-affiliated payees to which disclosure of costs may be required under the rule because the MMS determines a transaction is not arms-length or on other shippers that may be entitled to the cost information because it was disclosed to a pipeline's marketing affiliate.

The MMS has also failed to include any calculation of the cost of the administrative burden imposed on the affiliated lessee/shipper, on the affiliated pipeline/transporter or even on the MMS itself in having to audit these costs instead of being able to rely on the tariff established by FERC. The MMS fails to include any analysis or any indication there has been an analysis of whether the differences between the costs of a pipeline affiliate, as calculated in accordance with the proposed rule, and FERC tariffs will exceed the additional costs imposed on producers, their affiliated pipeline companies and on the MMS itself under this proposed rulemaking.

The preamble also states at page 73823 that "In addition, lessees have always borne all of the marketing costs." This statement is not correct. When a sale occurs at the lease, the costs of marketing the oil or gas downstream of the lease is a component in determining the value at the wellhead. The MMS recognizes this even now in allowing for location and quality differentials in its proposed valuation rules. Later on the same page the MMS states that "How the lessee markets its production is its decision. The lessor is entitled to its royalty share of the total value derived from the production regardless of how the lessee chooses to dispose of it." This statement is correct only if the MMS recognizes that the royalty is to be valued at the lease under the terms of the existing statutes and lease provisions, and any value should be determined on this basis. The proposed rule in §206.106 is overly broad and vague and should be limited to those expenses necessary to put the production in marketable condition at the lease.

The rulemaking as proposed will only increase the administrative burden on both the lessees and the federal government and ultimately result in numerous administrative appeals and inevitable costly and inefficient litigation. Unocal urges the MMS to withdraw the proposed rulemaking and to reconsider the issues in light of this and other industry comments, as well as the comments of the State of Wyoming opposing the proposed regulations. It urges the MMS to consider expanding its royalty in kind program for oil as an alternative to the confusion and uncertainty inherent in the proposed rule.

Sincerely,

UNION OIL COMPANY OF CALIFORNIA

By: M. A. Jones

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